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No. 416

In the Supreme Court of the United States

OCTOBER TERM, 1970

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES W. AND DOROTHY F. STRADMAN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1970

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES W. AND DOROTHY F. STEADMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

tiorari to and including August 8, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether an attorney's loss on the worthlessness of stock in a corporate client, acquired to avoid the loss of the corporation as a client, is a loss on the worthlessness of a capital asset defined in Section 1221 of the Internal Revenue Code.

STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

STATEMENT

Respondent,[1] a partner in a Cleveland law firm and a specialist in the field of corporate finance and organization, was general counsel to the Richards Music Corporation. He had helped organize the corporation, and expected to furnish legal services to it in the future, since its management anticipated the acquisition and amalgamation of several musical instrument companies into a single organization offering a complete line of musical instruments. Respondent was assured by Paul E. Richards ("Richards"), chief executive

[1] All references to "respondent" are to Charles W. Steadman. Dorothy F. Steadman is a party to this action only because a joint income tax return was filed.

officer and principal stockholder of the corporation, that he would remain general counsel to the corporation so long as Richards was in control of the corporation. (Appendix A, *infra*, p. 8.)

In 1961, after the corporation had embarked upon a costly program of acquisitions and mergers, Richards' control was jeopardized. The American Research and Development Corporation of Boston had previously advanced the corporation $750,000, in exchange for debentures convertible into common stock, and three of the nine board of directors' seats. It now offered to purchase any new stock offered to raise additional capital, provided that the board was increased to ten members, five of whom would be selected by the debenture holders. Implicit in this offer was American's bid for effective control of Richards Music, resulting from its veto power on the board and its potential ownership of a majority of the shares by conversion of the debentures. American Research made it clear that if it gained control, it would make a change in management and transfer the corporation's legal business to its own Boston law firm. Respondent thus was aware that acceptance of the American Research offer was likely to result in the loss of the legal fees he earned as general counsel to Richards Music. (Appendix A, *infra*, pp. 9–10.)

To head off American Research's bid for control, a resolution was passed providing for the issuance of 140,000 new shares of Richards Music capital stock for $370,000, to be offered first to Richards Music's shareholders of record. Such shareholders other than respondent were willing to purchase 70,000 shares,

and respondent was able to purchase 32,000 shares for $80,000.[2] The remaining 38,000 shares, which were not taken up by shareholders, were sold to outsiders (Appendix A, *infra*, p. 10).

Subsequent to the issuance of the additional capital stock, Richards Music suffered business losses, and it eventually was involved in a Chapter XI bankruptcy proceeding, with the result that respondent's stock in Richards Music became worthless (Appendix A, *infra*, pp. 10–11). Respondent treated the $80,000 loss he suffered on the worthlessness of this stock as an ordinary loss. In his deficiency notice, the Commissioner asserted that the loss was a capital loss.

The Tax Court held that the stock was not a capital asset in respondent's hands because he had purchased it to retain Richards Music as a client and to insure a continuing source of legal fees, rather than with the expectation of dividends or capital growth. It accordingly allowed respondent an ordinary loss. On appeal, the Sixth Circuit affirmed.

REASONS FOR GRANTING THE WRIT

The issue raised in this case is essentially the same, in a different setting, as that presented in the government's petition for a writ of certiorari in *United States v. Waterman, Largen & Co., Inc.*, filed this day.[3] In *Waterman, Largen*, the Court of Claims allowed an ordinary loss after finding that the loss of the taxpayer's client would have resulted in serious

[2] Respondent had earlier purchased 12,000 shares of Richards Music which are not here involved (Appendix A, *infra*, p. 10).

[3] Copies of our petition in *Waterman, Largen* are being served on counsel for respondent herein.

injury to its business. The court below allowed respondent an ordinary loss even though he made no showing as to extent of injury to his law practice that would have resulted from the loss of Richards Music as a client. Since, in our view, a business purpose for an acquisition of corporate stock, no matter how urgent, cannot convert the stock from a capital into a noncapital asset, we do not believe that the distinction is material to the disposition of the two cases.

CONCLUSION

For the reasons stated in our petition in *Waterman, Largon*, on which we here rely, the instant petition should also be granted.

Respectfully submitted.

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Attorneys.

JULY 1970.

APPENDIX A

No. 19486

United States Court of Appeals for the Sixth Circuit

CHARLES W. STEADMAN AND DOROTHY F. STEADMAN, APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

On Appeal from the Opinion of the Tax Court of the United States

Decided April 10, 1970

Before PHILLIPS, Chief Judge, CELEBREZZE, Circuit Judge, and O'SULLIVAN, Senior Circuit Judge.

O'SULLIVAN, Senior Circuit Judge. This is an appeal by the Commissioner of Internal Revenue from a decision of the Tax Court reported as *Charles W. Steadman*, 50 T.C. 369 (1968). Therein the Tax Court held valid the taxpayers' claim of an ordinary loss deduction for the year 1962, in the amount of $80,000 being taxpayers' purchase price for shares of corporate stock which became worthless in the year 1962. The Commissioner contends here, as he did in the Tax Court, first that the loss did not occur in the year 1962; and second, that the loss was a capital loss which could not be deducted from ordinary income as a business loss. The Tax Court ruled against the Commissioner on both contentions. Five dissenters, however, held that the loss did not occur in the year 1962, but did not rule upon the Commissioner's second contention. They said:

"In view of the conclusion [that the loss did not occur in 1962] there is no need to consider whether petitioner sustained his burden of proof that the loss was a business loss * * *."

We affirm.

Charles Steadman was a partner in a Cleveland law firm. His practice was primarily in the field of corporate finance and organization. In the spring of 1960, one Paul E. Richards contacted Steadman with regard to a plan for the acquisition and amalgamation of several musical instrument companies into a single, integrated manufacturing and marketing organization. Richards offered Steadman the position of general counsel and assured him that he would remain general counsel of the proposed corporation so long as Richards retained control of its management. Based on the nature of the proposed organization, and the prospect of many acquisitions and mergers, generating substantial legal fees, Steadman estimated that something over $30,000 per year in legal fees would accrue to him as general counsel. Under Steadman's partnership agreement with his law firm, all of these fees, less a percentage to cover the overhead expenses of the law firm, would go to Steadman.

The establishment of the contemplated corporation was carried out as set forth in the Tax Court opinion, as follows:

"Petitioner accepted Paul Richard's offer and, as a first step in executing the plan, organized the Richards Music Corp. (herein referred to as Richards Music) as the principal corporate entity. Then, on December 30, 1960, the Blessing Band Instrument Co. was merged into Richards Music, and the stock of the Martin Band Instrument Co. and the assets of the Reynolds Band Instruments Co. were acquired by Richards Music. The resulting entity became

operational at this time with petitioner as its secretary, general counsel, and member of the board of directors. In early 1962, the name of Richards Music Corp. was changed to Richards Musical Instruments, Inc.

"To finance the merger and acquisition, Richards Music borrowed $750,000 from American Research & Development Corp. of Boston, Mass. (herein referred to as American Research), in exchange for 6-percent, convertible subordinate debentures, which were convertible into common stock of Richards Music at $3 per share.

"Immediately following the merger and acquisitions, the board of directors of Richards Music consisted of nine members, five (including petitioner) representing the shareholders, three representing American Research, and one representing Wurlitzer Co. which had acquired notes and debentures of Richards Music in return for the stock of the Martin Band Instrument Co."

The validity of Steadman's estimate of the yearly earnings that would come to him as general counsel for the newly formed corporation is not challenged; neither is the value of the service performed by Steadman and an associate during the years 1961 through 1961 questioned. Such value exceeded $30,000 in each year. Because of the company's financial problems, the actual payments to Steadman totalled $47,036.58 for these four years, as against the total value of the service of $144,615.50.

By the summer of 1961, it became apparent that further financing was critically necessary to complete plans for further acquisitions. American Research & Development Corp., which was already the holder of $750,000 face value of Richards Musical Instruments, Inc. convertible debentures, offered to provide additional financing by purchasing newly issued shares in

the amount of $350,000, conditioned upon an increase in the number of directors to ten, five to be selected by the debenture holders. Implicit in this offer was a bid by American Research for control of Richards Music. American Research made it clear that such control would be followed by a change in management and the concentration of legal activities in the Boston law firm handling the business of American Research. Steadman was thereby made aware that acceptance of the American Research offer and plan would likely cause him to lose his position and become assistant counsel of Richards Music. To maintain his position it was imperative that some other financing arrangement be secured. In response to American Research's offer, the Board of Richards Music passed a resolution authorizing the issuance of 140,000 new shares of capital stock in the amount of $350,000, but to be offered first to the shareholders of record, at $2.80 per share. Steadman was already the owner of 12,000 shares of Richards Music which he had earlier purchased. These shares are not here involved. The shareholders of record, other than Steadman, were willing to purchase only 70,000 shares. Through a New York brokerage house, Steadman arranged the purchase of the remaining 70,000 shares, 32,000 held for his own account and financed by a Cleveland bank's loan to Steadman. Steadman's loss of $80,000 when the shares he purchased for that amount became worthless is the subject matter of this litigation.

Subsequent to this purchase, Richards Music suffered business losses, the extent of which were not revealed fully until an external audit by Ernst & Ernst, covering the calendar year 1962, was furnished on March 27, 1963. This external audit revealed a net deficit in shareholder's equity of $456,109.19, a net

operating loss of over $1.3 million, and an excess of current liabilities over current assets of over $100,000. These figures supported the fears of the Board, aroused in December of 1962, that the management of Richards Music had been presenting the Board with false figures and that Richards Music was, in reality, in dire financial straits. The Board met in January of 1963, replaced Paul Richards as president and began consideration of what could then be done with Richards Music. Business operations continued through 1963, but the Ernst & Ernst audit for that year confirmed the fact that Richards Music had no prospect for continued existence. On April 15, 1964, a Chapter XI bankruptcy proceeding was filed in federal district court. Steadman's shares had become, and remained, worthless.

We consider the questions presented in this order:

1. The year of loss.

The Tax Court held that Steadman's $80,000 loss occurred in the year 1962. The Commissioner contends that it occurred in 1963. Resolution of such contest involves a finding of fact. The Tax Court found, as a matter of fact, that the loss occurred in 1962. Unless we can say that such finding was clearly erroneous, we are not at liberty to set it aside. *Commissioner v. Duberstein*, 363 U.S. 278, 289 (1960). The Commissioner's brief to this Court states the rule as follows:

> "The cases in this area are consistent with the Regulations; they have consistently held that when stock or securities become worthless is a question of fact to be determined from an examination of all the facts and circumstances of the case. It is generally agreed that no single factor is determinative of the issue (*Boehm v. Commissioner*, 326 U.S. 287 (1945)), and it is

equally well-settled that the burden of establishing worthlessness, as well as the year of its occurrence, is on the taxpayer (*Lincoln Bank & Trust Co. v. Commissioner*, 51 F.2d 78 (C.A. 6th, 1931)).

The Tax Court determined that the capital stock of Richards Music was worthless as of December 31, 1962. This finding was based upon the computed balance sheet prepared by Touche Ross covering the year 1962 and revealing a large net operating loss and the net deficit in the shareholders' equity. The Tax Court also noted that in appraising the stock's worth in current assets over current liabilities, account should be taken of the fact that a relatively large amount of the current assets consisted of unfinished goods in inventory. We do not consider that the Tax Court intended to hold that Richards Music was in net insolvency as of December 31, 1962. We read his pronouncement to be that those controlling the corporation in 1963 were not without hope that implementation of plans then underway would restore some worth to its shareholders' equity. These plans were carried out, and as they are set out in detail in the Tax Court opinion we will not detail them here. The Tax Court's view was that the plans of 1963 had for their primary objective the solvency of Richards and that the company's petition for reorganization [illegible] apparently that there must be a showing of an "identifiable event" which would confirm the [illegible]

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* The Tax Court's opinion recites:

"An external audit, dated March 7, 1963, prepared by Touche Ross and Trust as of December 31, 1962, revealed a net loss [illegible] for the year of $1,311,000, an excess of current liabilities over current assets of $1,090,000, and a net deficit in the shareholders' equity of $166,000. Of the $1,305,733 in current assets, $591,000 represented unfinished inventory and [illegible] consisted of cash."

loss. Disposing of this question, the Court quoted this language from its decision in *Sterling Morton*, 38 B.T.A. 1270 (1938):

> "There are, however, exceptional cases where the liabilities of a corporation are so greatly in excess of its assets and the nature of the assets and business is such that there is no reasonable hope and expectation that a continuation of the business will result in any profit to its stockholders, so that, as to such cases the stock, obviously, has no liquidating value, and since the limits of the corporation's future are fixed, the stock, likewise, can reasonably be said to have no potential value. Where both these factors are established, the mere fact that a date of an accidentifiable event in the corporation's life such as liquidation or receivership, will not, therefore, determine the worthlessness of the stock, for already its value has become finally extinct." 38 B.T.A. at 1279.

The Tax Court's crucial holding was that after 1962 there was no reasonable expectation of future profit to the shareholders of Richards Music, and that a prudent businessman would have ascertained the stock was worthless." The Commissioner here cites this Court's opinion in *Deeds v. Commissioner*, 47 F(2) 695 (6th Cir. 1931). It will be sufficient to say that there we affirmed the Board's finding of fact, and in *Morton v. Commissioner of Internal Revenue*, 112 F(2) 320, the Seventh Circuit affirmed the findings of fact by the B.T.A., saying:

> "The worthlessness of a stock as of a particular year is a question of fact requiring practical consideration of all the facts and circumstances, and each case must stand on its own facts. St. Louis Union Trust Co. v. United States, 8 Cir., 82 F2d 61, 66; Forbes v. Commissioner, 4 Cir. 62F.2d 571; and Industrial Rayon Corp. v. Commissioner, 6 Cir., 94 F2d 383. We of

course, are bound by the rule that where there is substantial evidence to support the Board's finding upon a question of fact, its decision of such a question is conclusive upon review, and the conclusions must be accepted. Helvering v. Rankin, 295 U.S. 123, 55 S. Ct. 732, 79 L.Ed. 1343; Palmer v. Commissioner, 302 U.S. 63, 58 S.Ct. 67, 82 L.Ed. 50; Helvering v. National Grocery Co., 304 U.S. 282, 294, 58 S.Ct. 932, 82 L.Ed. 1346; Sacks v. Commissioner, 4 Cir. 66 F.2d 308; and Jones v. Commissioner, 9 Cir., 103 F.2d 681, 684." 112 F(2) at 324.

We hold that substantial evidence supported the Tax Court's finding. It was not clearly erroneous.

2. Was the loss deductible from ordinary income.

Our earlier factual recital sets out the emergency that prompted Steadman to borrow $80,000 to purchase the 32,000 shares of Richards Music. He had already owned 12,000 shares as a capital investment, the loss of which is not claimed here. The only reasonable view that can be taken of Steadman's borrowing of $80,000 to acquire the shares here involved is that he did so to protect his position as general counsel for Richards Music and the earnings necessarily flowing from such position. Such was the holding of the Tax Court. The Commissioner recognized this in his statement to us that,

> "The taxpayer here, an attorney, purchased stock in a client corporation, not with the expectation of dividends or capital growth, but in order to retain the corporation as a client affording substantial fees for legal services."

Admittedly, if the company's 1961 needs had been financed by sale of new stock to American Research, holder of debentures, control of management would have gone to that concern and the legal work would have been transferred to a Boston law firm. In holding that Steadman's 32,000 shares of Richards Music

was not a capital asset, the loss of which could only be charged against capital gains, the Tax Court said:

> "Whether an asset normally considered capital in nature is an integral part of a taxpayer's business so as to render a loss suffered with respect to it deductible as an ordinary loss is essentially a fact question. In making this determination, it must be borne in mind that the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly so as to effectuate the basic congressional purpose. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46 (1955)." 50 T.C. at 379.

The question now before us has been presented in a variety of factual situations. In *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), the Supreme Court was dealing in "corn futures". In *Booth Newspapers, Inc.* v. *United States*, 303 F(2) 916 (U.S. Ct. of Claims, 1962) the Court of Claims held that stock purchased by newspaper publishers in a paper mill company to protect its paper supply was not a capital asset. The Court's opinion there produced the following syllabus:

> "If securities are purchased by a taxpayer as an integral and necessary act in conduct of his business, and continue to be so held until time of their sale, any loss incurred as result thereof may be fully deducted from gross income as a business expense or ordinary loss, but if an investment purpose motivated purchase or holding of securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of Internal Revenue Code, 26 U.S.C.A. (I.R.C. 1954) § 1221." 303 F(2) at 916.

We need not consider whether, had Richards Music survived to go on to a profitable future, and Steadman continued to hold his shares, they might have

become capital assets when holding them was no longer necessary to protect Steadman's business. However, whatever their value, the Tax Court held that they never acquired the status of capital assets during their short period of survival. The Tax Court's position here has been sustained in the following decisions of the United States Court of Claims, *Waterman, Larson & Co., Inc.* v. *United States*, 419 F.(2) 845 (U.S. Ct. of Claims, Nov. 14, 1969); *Pan Am. Agency Corporation, Inc.* v. *United States*, — F.(2) — (U.S. Ct. of Claims, 1969) and *F.S. Services, Inc.* v. *United States*, — F.(2) — (U.S. Ct. of Claims, 1969).

We hold that Steadman's $80,000 loss in 1962 was deductible from ordinary income.

The judgment of the Tax Court is affirmed.

APPENDIX B

United States Court of Appeals for the Sixth Circuit
No. 19,486

CHARLES W. STEADMAN AND DOROTHY F. STEADMAN,
PETITIONERS-APPELLEES

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

Before PHILLIPS, *Chief Judge*, CELEBREZZE, *Circuit Judge* and O'SULLIVAN, *Senior Circuit Judge*.

On appeal from a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

It is further ordered that Petitioners-Appellees recover from Respondent-Appellant the costs on appeal, as itemized below.

Entered by order of the Court.

CARL W. REUSS,
Clerk.

Costs: None.
Filed
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OCTOBER TERM, 1970.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

CHARLES W. and DOROTHY F. STEADMAN,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT.

BRIEF OF RESPONDENTS IN OPPOSITION.

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Statutes and Regulations.

Code of Federal Regulations, Title 26, Part 1:

Regulation 1.165-5 4, 7

Regulation 1.1221-1 4, 7

Internal Revenue Code of 1954 (26 U.S.C.):

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In the Supreme Court of the United States

No. 416.

OCTOBER TERM, 1970.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

CHARLES W. and DOROTHY F. STEADMAN,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT.

BRIEF OF RESPONDENTS IN OPPOSITION.

QUESTION PRESENTED.

1. Whether the Courts below correctly held that taxpayer's loss on the worthlessness of corporate stock acquired and held to preserve and to protect the legal business of the taxpayer was deductible as an ordinary business expense.

STATUTES AND REGULATIONS.

The Commissioner sets forth Sec. 1221 of the Internal Revenue Code of 1954 (26 U.S.C.) as the Statute involved herein. Also relevant are:

Internal Revenue Code of 1954 (26 U.S.C.):

Section 165, Losses.

Subsection (a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Subsection (b) Amount of Deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

Subsection (c) Limitation On Losses of Individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100. limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been

claimed for estate tax purposes in the estate tax return.

Subsection (g) Worthless Securities.—

(1) General Rule.—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) Security Defined.—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) Securities In Affiliated Corporation.—For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as capital asset.

For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities,

and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

Code of Federal Regulations, Title 26 Part 1:

Section 1.165-5. Worthless Securities.

Subsection (a) Definition of Security.

As used in Section 165 (g) and this section, the term "security" means

(1) A share of stock in a corporation;

(2) A right to subscribe for, or to receive, a share of stock in a corporation; or

(3) A bond, debenture, note or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued with interest coupons or in registered form by a domestic or foreign corporation or by any government or political subdivision thereof.

Subsection (b) Ordinary loss.

If any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under Section 165 (a) as an ordinary loss.

Section 1.1221-1 Meaning of terms.

Subsection (a) The term "capital assets" includes all classes of property not specifically excluded by section 1221. In determining whether property is a "capital asset," the period for which held is immaterial.

STATEMENT OF THE CASE.

The Commissioner's statement of the facts in his Petition is essentially accurate. His statement that 38,000 shares of Richards Music stock were sold to outsiders is somewhat misleading. These shares were subscribed for by Respondent, issued to a stock brokerage firm, headed by a friend and associate of Respondent which was brought into the picture by Respondent, and the shares were held by said brokerage firm for itself and for friends of the head of the firm. The Commissioner's statement concerning the time of worthlessness (Petition, p. 5) is also misleading since the Courts below found as a fact that Respondent's stock became worthless in 1962, prior to the institution of the Chapter XI bankruptcy proceeding (Petition, App. A., p. 11).

What is missing from the Commissioner's statement of the case is a recitation of any sufficient facts or reasons to warrant a review by this Court on certiorari of the decision below.

This is not a case where the court of appeals has rendered a decision in conflict with that of another court of appeals, nor does it involve any important question of law that has not already been settled by this Court. Neither does it involve a decision on any federal question that conflicts with applicable decisions of this Court.

ARGUMENT.

The commissioner states under his heading "Reasons For Granting the Writ" (Petition, p. 5) that the issue involved in this case is essentially the same as in the case of *United States v. Waterman, Largen & Co., Inc.* and relies on the reasons stated in the petition for a writ of certiorari filed in this Court in that case in asking that the instant petition be granted.

The Commissioner does distinguish the *Waterman, Largen* case on the basis that in the instant case the respondent made no showing as to the extent of injury to his law practice that would have resulted from the loss of Richards Music as a client (Petition, p. 6). This statement is made in the face of the findings of the Court below that the value of the services rendered by respondent to this client during the years 1961 through 1964 totalled $144,615.50 and in the face of the Commissioner's own statement to the Court of Appeals that respondent purchased the stock in question in order to retain a client "affording substantial fees for legal services" (Petition, Appendix A, p. 14). It is surely obvious that the loss of a client producing an average of $36,000 of fees per year is injurious to any attorney's practice and that the dollars involved speak for themselves as to the extent of the injury.

The Commissioner then states (Petition, p. 6) that in his view a business purpose for the acquisition of corporate stock never results in such stock attaining the status of a noncapital asset. This viewpoint seems to ignore prior decisions of this Court, the Commissioner's own Regulations, and numerous lower courts' decisions to the contrary.

The decision of this Court in *Corn Products Co. v. Commissioner*, 350 U.S. 46, holds at p. 52, that the prefer-

ential tax treatment provided by Section 117 of the Internal Revenue Code of 1939, now Section 1221 of the 1954 Code, "applies to transactions in property which are *not* the normal source of business income." (Emphasis added.) The holdings of the courts below in the instant case are entirely consistent with that interpretation of the statute since respondent's sole reason for entering into the transaction in issue was to retain for himself as an attorney a normal source of his business income, namely legal fees from a valued client. (Petition, Appendix A, p. 14.)

The regulations themselves recognize that corporate stock is not always a capital asset. Regulation 1.165-5(b) states that:

> "If any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss."

Both the regulations and the statute, Section 165, define the term "security" to include a share of stock in a corporation.

The Commissioner would also seek to develop a rule that stock should always be classified as a capital asset if it may be held by a taxpayer indefinitely. This is in the face of his own regulations which state explicitly that in determining whether property is a capital asset, the period for which it is held is immaterial. Regulation 1.1221-1.

The Commissioner's principal reason for seeking review really seems to be that it just isn't fair for the taxpayers in this and the *Waterman, Largen* case to be allowed a deduction for an ordinary loss because there is a possibility, created solely in the mind of the Commissioner, that if their respective stocks had appreciated and been sold at a profit, the taxpayers *might* have been successful in claiming capital gain treatment. This argument is based

totally on conjecture and should afford this Court no reason for finding that this case, decided correctly, based on its own uncontroverted facts, deserves review by this Court. In making this argument, the Commissioner chooses to ignore the instances when he has been successful in arguing that an asset acquired for business purposes and sold at a profit was not a capital asset and therefore that such profit was taxable as ordinary income. *Corn Products vs. Commissioner*, 350 U.S. 46; *Mansfield Journal Co. v. Commissioner*, 274 F.2d 284 (CCA 6, 1960); *Journal Co. v. U. S.*, 195 Fed. Supp. 434 (E.D. Wisc., 1961). Neither the results of these cases nor that of the instant case and the *Waterman, Largen* case indicate that any conflict, confusion or great and substantial problem exists requiring resolution by this Court. Each such case is decided by application of the sound, clear-cut and definitive doctrine set forth by this Court in *Corn Products* and applied consistently, reasonably and without confusion by the Courts to the particular fact circumstances before them. The fact that consistent application of a well-understood principle of law to varying sets of facts produces varying results in no way shows miscomprehension or misapplication of the principle but only illustrates that each such case must be decided on its own established facts. The Commissioner's argument appears even more fallacious when one considers that in all instances the taxpayer has the burden of proof in establishing the facts necessary to justify his reported treatment of a taxable event.

This plaintive appeal by the Commissioner also ignores the fact that the Code itself requires varying tax treatment for profits and losses in many instances. Section 1231 provides that gains on the sale of certain personal and real property used in a trade or business are capital

gains while losses on the sale of such property are ordinary losses. If the subject case had arisen because respondent had purchased a set of law books for use in his practice which became obsolete and therefore worthless to him and he had claimed an ordinary loss deduction, there is no doubt that his claim would never have been questioned. If on the other hand, the set of books was discovered to be a rare edition and was sold at a substantial profit, there is equally little doubt that the gain would be a capital one. Is there any difference in substance between that hypothetical situation and the instant case, where the courts below found as a fact that respondent purchased stock in a corporation to retain a client affording him substantial fees? Both the set of books and the capital stock were purchased for the purpose of being used in respondent's business. We submit that the Commissioner's belief that one situation is fair and the other not offers no sound reason for this Court to review an essentially factual determination by the courts below which found that respondent was entitled to an ordinary loss deduction.

Similarly, sale of certain qualified stock in a small business corporation (Section 1244 of the Code), or of stock in a small business investment company (Section 1242 of the Code), at a gain is taxed as a capital gain while sale of the same stock at a loss results in an ordinary loss deduction; while on the other hand, sale of certain stock in foreign corporations (Sections 1246, 1248 of the Code) at a gain may be wholly or partially taxed as ordinary income although sale at a loss of the same stock held for the same period of time by the identical taxpayer could be a capital loss.

We believe and suggest that if the Commissioner feels that the results of this case are unfair, the appropriate

place for him to seek relief is in the Congress of the United States, where he can request new legislation, rather than in the Supreme Court of the United States, where he now inappropriately seeks this Court's review of a decision based on a sound analysis of concurrent findings of facts by the two courts below (Petition, Appendix A, p. 14), applying well-settled principles of law previously enunciated by this Court in *Corn Products*, and applied consistently, correctly and without conflict by the lower federal courts (Petition, Appendix A, p. 15, cases cited p. 15 and p. 16).

As aptly stated by this Court in *Graver Tank & Manufacturing Company, Inc. v. Linde Air Products Co.*, 336 U.S. 271, at 275:

> "A court of law, such as this Court is, rather than a court for correction of errors in fact finding, cannot undertake to review concurrent findings of fact by two courts below in the absence of a very obvious and exceptional showing of error."

The question involved in this case is whether the stock of Richards Music, acquired under the circumstances and for the purposes determined by the courts below, constituted a capital asset in the hands of respondent. This is a factual issue of the type which this Court has consistently declined to review, *Layne & Bowler Corporation v. Western Well Works*, 261 U.S. 387; *Southern Power Co. v. No. Carolina Public Service Co.*, 263 U.S. 508; *Rudolph v. U. S.*, 370 U.S. 269; *Berenyi v. District Director, Immigration Service*, 385 U.S. 630.

The Commissioner's attempt to distinguish capital stock from other classes of property acquired for business purposes misses a very vital point. Although he cites the familiar principle that "the incidence of taxation depends upon the substance of a transaction," the Commissioner

does not recognize the fact that in the instant case and in similar cases such as *Booth Newspapers, Inc. v. U. S.*, 157 Ct. Cl. 886, 303 F.2d 916, and the cases discussed therein, the taxpayer is not acquiring stock for the purpose of owning stock, he is not in reality acquiring stock for its classic purpose, he is acquiring through the medium of stock a different asset or property, a thing needed in his regular business. In the instant case, the thing acquired was a continuing source of legal fees; in *Booth Newspapers*, it was a source of raw materials needed in the taxpayer's business. The Commissioner recognizes the above point in analyzing the *Corn Products* case (*Waterman, Largen* Petition, p. 11) yet he refuses or fails to recognize that there is no difference in substance between acquiring corn futures to insure a source of supply of corn and acquiring capital stock to insure a source of supply of corn. The taxpayer's intent and purpose and the end result sought to be achieved, not the means by which accomplished, is the "substance" which governs the tax treatment to be accorded the transaction.

The Commissioner approves the holdings in *Corn Products* and *Western Wine & Liquor Co. v. Commissioner*, 18 T.C. 1090, on the basis that they properly hold that a taxpayer which acquires one asset solely to obtain another will be deemed to have acquired the latter asset despite the form of the transaction. The Commissioner's attempt to distinguish the instant case from the decisions he approves truly exacts form over substance since the Courts below found that:

> "The only reasonable view that can be taken of Steadman's borrowing of $80,000 to acquire the shares here involved is that he did so to protect his position as general Counsel for Richards Music and the earnings necessarily flowing from such position. Such was the

holding of the Tax Court." (Petition, Appendix A, p. 14.)

Thus the Courts below found as a fact that Respondent acquired the capital stock in question only to acquire something else—a continuing source of business for his law practice, and their decisions herein are entirely in accord with, and are in fact required by, the very doctrine which the Commissioner approves.

The Commissioner's last appeal for review is based on the "burden" imposed upon him by the *Corn Products* doctrine coupled with a complaint that taxpayers have been too successful in winning cases involving the doctrine. This seems to offer no better reason for review than the inadequate ones which precede it. Many correct decisions impose a burden on taxpayers, both in particular and in general, which does not, of course, alone justify any taxpayer seeking a review of such decisions by this Court. It also seems rather doubtful that this Court would accept any taxpayer's case for review because of a claim that the Commissioner was winning too many cases involving a similar issue.

CONCLUSION.

The decision below was correct and no appropriate reasons have been cited nor do any exist for review of said decision by this Court. The Commissioner's Petition should be denied.

Respectfully submitted,

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Counsel for Respondents.

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Nos. 415, 416

In the Supreme Court of the United States

OCTOBER TERM, 1970

UNITED STATES OF AMERICA, PETITIONER

v.

WATERMAN, LARSEN & CO., INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES W. AND DOROTHY F. STEADMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES AND THE COMMISSIONER

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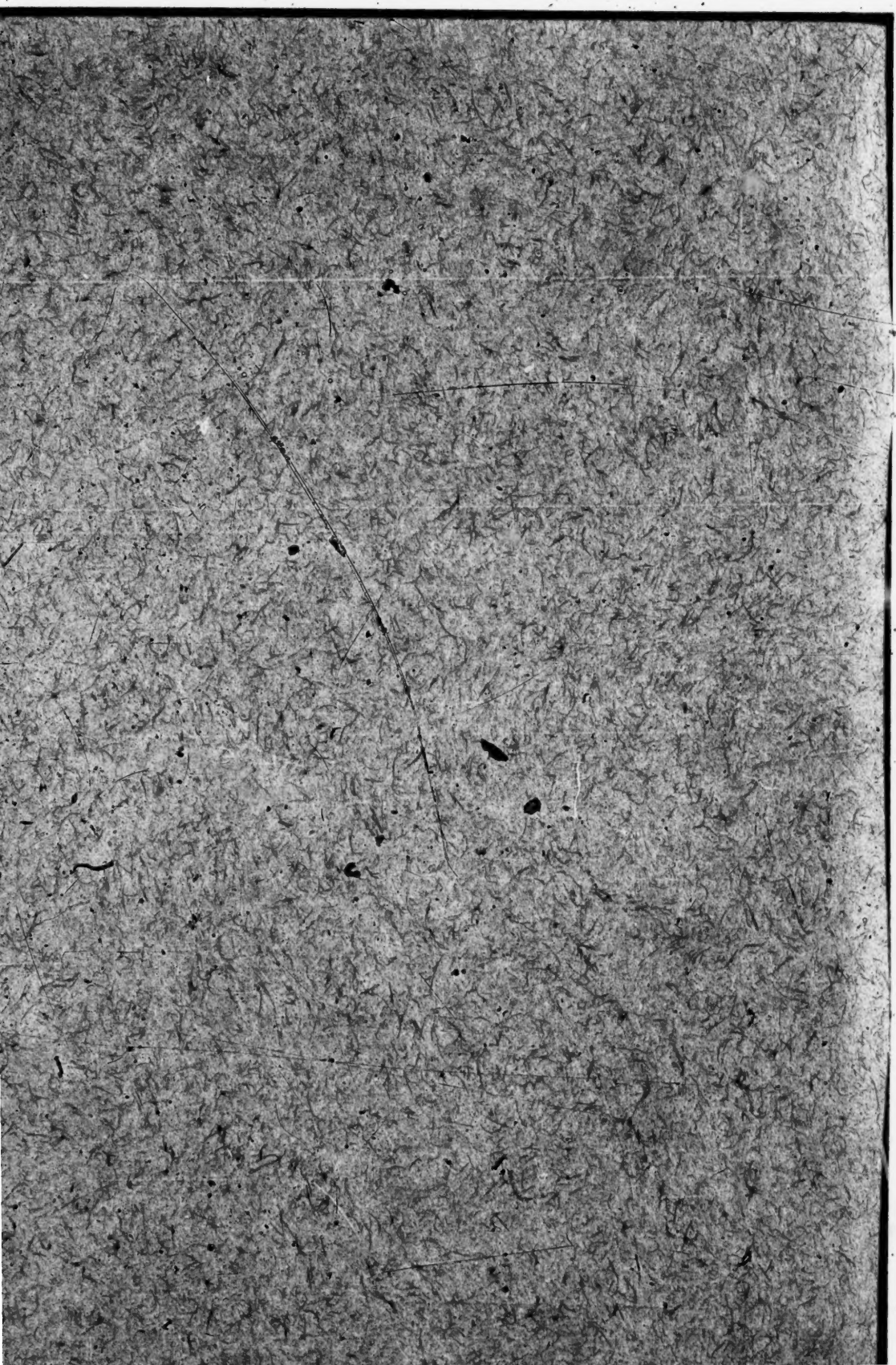

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1. The briefs in opposition in these cases themselves demonstrate the need for prompt review and correction by this Court.

Respondents concede (Br. (No. 415) 8; Br. (No. 416) 10) that they acquired capital interests in corporations; Waterman, Largen concedes (Br. (No.

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415) 5–6) that the Court of Claims' construction of *Corn Products Co. v. Commissioner*, 350 U.S. 46, cannot be squared with the language of Section 1221, which says in the plainest terms that the characterization of an asset as capital or non-capital is to be made without regard to whether that asset is connected with the taxpayer's trade or business. It also concedes (Br. (No. 415) 11) that the lower court applied the standards of Section 166, relating to business bad debts, even though that provision has no bearing whatever upon losses on the sale of stock. Steadman concedes (Br. (No. 416) 8–9) that the Sixth Circuit in effect applied the standards of Sections 1231, 1242 and 1244—standards allowing taxpayers capital treatment on gains and ordinary treatment on losses in carefully delineated circumstances—despite the fact that those provisions admittedly are inapplicable here.[1]

After all these concessions, however, respondents oppose review by this Court. They do so on the ground (Br. (No. 415) 6–8, 10–11; Br. (No. 416) 7–8) that the issue in these cases is factual in nature. But the issue here is whether the capital asset provision—Section 1221—is to be read out of the income tax law in cases where corporate stock

[1] Steadman asks rhetorically (Br. (No. 416) 8–9) why different rules should apply to his depreciable law books, on the one hand, and stock purchased for a business purpose, on the other. The answer is that Section 1221(2) excepts depreciable property from the definition of a capital asset if it is used in a taxpayer's trade or business; it does not except capital stock from that definition "whether or not connected with his trade or business." In short, Congress has provided one rule for depreciable business property and another for stock.

is acquired for a "business purpose." That is clearly a legal issue.[2] One need read no further than the "Statutes Involved" portions of the briefs in opposition (Br. (No. 415) 1–2; Br. (No. 416) 2–4) to confirm this, for neither respondent has cited Section 1221, which is captioned "CAPITAL ASSET. DEFINED." Moreover, there is no dispute as to the salient underlying facts. All that remains for this Court to decide is whether a "business purpose" for a stock acquisition can convert that stock from a capital into a non-capital asset.

2. In No. 415, three business entrepreneurs organized and capitalized the Elmvale-Laurens corporation and owned its capital stock. Each had an interest in a long-term venture; each had a particular reason for investing. Carey Kinney wanted (Pet. (No. 415) App. 28) "to insure his son's business future." Nichols

[2] Respondents point out (Br. (No. 415) 6–7; Br. (No. 416) 8) that, in the past 15 years, there have been a few instances in which lower courts have invoked *Corn Products* in the government's favor. From this, they make the curious and transparently incorrect argument that all purported applications of *Corn Products* must be deemed factual *regardless of the legal standard used*. In addition, in reliance on the same cases, they dispute our contention (Pet. (No. 415) 14–15, 19–20) that the potentially limitless "business purpose" concept, which has come to full fruition in recent years, cannot be applied evenhandedly to taxpayers and the government alike (Br. (No. 415) 6–7; Br. (No. 416) 8). But, in this regard, respondents fail to cite a single case other than *Hollywood Baseball Association* v. *Commissioner*, 423 F. 2d 494 (C.A. 9), taxpayer's petition for certiorari pending, No. 157, this Term, in which the government has prevailed under a *Corn Products* rationale in the last seven years. Moreover, as we show in our brief in opposition in *Hollywood Baseball*, the *Corn Products* rationale was not essential to the result reached in that case.

Fiber wanted (Pet. (No. 415) App. 29) to "continue as the raw material supplier." Waterman, Largen wanted (*ibid.*) "to become sales agent for the mill's entire production." In No. 416, Steadman furnished permanent capital to a financially troubled client corporation (Pet. (No. 416) App. 14) "to protect his position as general counsel for Richards Music and the earnings necessarily flowing from such position." The notion that these diverse business motivations rendered the entire investment in Elmvale-Laurens and Steadman's investment in Richards Music non-capital in nature is completely foreign to the tax statute. Yet, this notion underlies the holdings below.

To avoid the rules that are applicable to capital stock, respondents argue (Br. (No. 415) 8–9; Br. (No. 416) 10–12) that they should be treated as having acquired other assets under the step-transaction doctrine. But that doctrine may properly be invoked only when the stock is acquired merely as an interim step in obtaining another asset. Thus, in *Western Wine & Liquor Co.* v *Commissioner*, 18 T.C. 1090, and in *Kimbell-Diamond Milling Co.* v. *Commissioner*, 14 T.C. 74, affirmed *per curiam*, 187 F. 2d 718, certiorari denied, 342 U.S. 827, the taxpayers sought specific assets owned by the corporations whose stock was acquired and had no interest in the continuance of the corporate ventures. They promptly extracted the desired assets and discarded the stock. In contrast, Waterman, Largen and Steadman were interested only in the continuing existence of Elmvale-Laurens and Richards Music, respectively, and in the latters' continuing success. Respondents did not acquire their

stock as a transient measure or an interim step in the acquisition of other assets, but rather to keep it for the long term. Their assertion that the step transaction doctrine applies in these circumstances to transcend their ownership of capital stock represents a clear perversion of that doctrine.

It thus makes no difference that Waterman-Largen might have received ordinary, rather than capital, treatment if it had sold a right to future brokerage commissions (Br. (No. 416) 8-9), or that Steadman might have received such treatment upon a sale of the "thing" he says he bought (Br. (No. 416) 11)—"a continuing source of legal fees." Since respondents purchased nothing less than full ownership rights in corporations,[3] and since they cannot be treated as having acquired other assets under the step transaction doctrine, the transactions here in question must be tested and taxed in accordance with the rules applicable to capital stock.[4]

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[3] This is particularly clear from the evidence in *Waterman-Largen*. Carey Kinney insisted (Pet. (No. 415) App. 29-30) that respondent "should have a substantial financial interest in the mill" so that the relationship would be "in the nature of a joint venture."

[4] Steadman argues (Br. (No. 416) 7) that the government's position is inconsistent with Treas. Reg. 1.1221-1, which provides that the holding period of an asset is not to be taken into account in determining its character. But the length of the holding period of stock is relevant only in determining whether the taxpayer should be treated as having acquired stock, or whether the stock acquisition should be considered an interim step, so that the taxpayer is deemed to have acquired an underlying asset. Once it is determined *what* asset the taxpayer is to be treated as having acquired, that asset is to be *characterized*, in accordance with the regulations, without regard to its holding period.

3. Only infrequently does the government find itself constrained to seek certiorari in tax cases which raise no conflict with a decision of another court of appeals. These petitions are unusual ones, predicated on what the government regards as an urgent need for reversal of the decisions below because the questions of statutory interpretation and application involved are basic and far-reaching. Respondents assert (Br. (No. 415) 12; Br. (No. 416) 9–10) that, for this purpose, Congress, rather than this Court, is the appropriate forum. However, a congressional amendment to the Code is not needed to require capital treatment in these cases. It is respondents, not the government, that ask that the present capital asset provision be scrapped.

Respondents tell us (Br. (No. 415) 6; Br. (No. 416) 8, 10) that the *Corn Products* principle is clear-cut and easy to apply. The commentators say the contrary. (See Pet. (No. 415) 15 n. 8 & n. 9.) Respondents tell us (Br. (No. 415) 8–10; Br. (No. 416) 8) that review by this Court would serve no purpose, that this Court's consideration of the issue would give rise to as many problems as it would solve. But the question is clearly a recurring one on which this Court's guidance would be useful to the lower courts. And, a reaffirmation by this Court of the basic principle that the step transaction doctrine may be applied only where one asset is acquired as an interim step in obtaining another would, in and of itself, resolve most of the problems raised by the *Corn Products* doctrine.

The lower courts have had 15 years of experience under *Corn Products*. During that time, they have

misunderstood its holding and, more recently, culminating in these cases, have expanded that holding beyond recognition. The point has now been reached where, absent elucidation by this Court, there is no longer a realistic prospect that *Corn Products* will be properly interpreted in the courts below. We urge, therefore, that the Court hear these cases and clarify the law.

Respectfully submitted.

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